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Analysing BEPS Impact  
Infrastructure sector

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In October 2015, the Organization for Economic Co-operation and Development ('OECD') released final reports on Base Erosion and Profit Shifting ('BEPS') in the form of 15 Action Plans with the objective to reform international tax system and ways to tackle tax avoidance. Clearly the emphasis of BEPS project is to increase transparency, satisfaction of substance test and the need to revamp international tax treaties to avoid situations like treaty shopping, double non-taxation as well as non-taxation of taxable activities through aggressive tax planning by some multinational companies. BEPS Action Plan will not only impact the tax planning done by the groups across jurisdictions but also have a bearing on well settled organizational structures and business models.

Being a developing economy, India has been one of the active participants of the BEPS project and it is expected that Indian Government would come out with significant enactment and amendments in its domestic tax laws in the forthcoming Budget 2016 to be in line with some of the critical BEPS recommendations impacting India.


Like many sectors, even infrastructure industry is anticipating millions or billions of additional tax due to BEPS action items. While most of the BEPS Action Plan is likely to impact infrastructure sector, some of the critical areas that industry should watch out for and take pro-active measures to align with the requirements are discussed below:

**Impact on infrastructure funding structures:**

Infrastructure projects have a large capital requirements and also long gestation period. A typical project will have construction period of atleast 3 to 4 years before it starts generating revenues. Apart from equity funding, such projects heavily relies upon debt funding eg. Loans, hybrid instruments like Compulsory Convertible Debentures ('CCDs'), etc. to finance the projects. Some of the BEPS recommendations discussed below, if implemented, could have significant impact on these infrastructure projects.

BEPS Action plan 2 intends to neutralize the effects of hybrid mismatch instruments. For instance, Hybrid instrument viz. CCDs is regarded as debt for deduction purposes in a country (say, India); whereas in lender's country, same is characterized as equity investment. Owing to the hybrid nature of instrument, it results into tax deduction in India and no tax outflow on dividend income in recipient's jurisdiction due to specific tax exemption. BEPS Action Plan 2 has suggested rules to deny the interest deduction or, alternatively, tax interest income in recipient's jurisdiction in order to neutralize undue advantage availed by the taxpayer.

Similarly, BEPS Action Plan 4 intends to address base erosion through use of interest and economically equivalent payments. The recommendation is that it should cover all interest – related party and third party, cross border and domestic. The Action Plan 4 recommends an approach based on a fixed ratio rule (limiting interest to fixed percentage of EBITDA), with a potential range of ratios (between 10% to 30%) to take into account that not all countries are in equivalent position. The fixed ratio approach can be supplemented by a worldwide group rule ratio.



From infrastructure perspective, OECD also recognizes the need to consider other factors in deciding fixed ratio and has proposed that a country may apply a higher ratio within the corridor where it applies a macro-economic policy to encourage third party lending not related to base erosion and profit shifting, but to increase investment e.g. in infrastructure. OECD has also suggested exemption to third party interest for funding public benefit projects which is privately-owned public-benefit assets financed through high proportion of debt. The OECD recognizes that because of the nature of the assets and the close connection with the public sector, such financing arrangements present little or no base erosion or profit shifting risk. If that be the case, infra companies may expect some exemptions or at least higher ratio for interest deduction depending on the economic and fiscal factors.

The above recommendations will adversely impact the funding structures of highly leveraged infrastructure sector and the infrastructure companies will have to reevaluate their global financing / income arrangements and the desired quantum of interest break in line with BEPS recommendations.

#### **Preferential regimes for transportation sector:**

Considering the operations of a typical shipping / airline companies in multiple locations and challenge in allocating appropriate revenues, such companies are granted preferential tax regimes.

Under the BEPS report, in order for a regime to be considered preferential, it must offer some form of tax preference in comparison with the general principles of taxation in the country. A preference offered by a regime may take a wide range of forms, including a reduction in the tax rate or tax base or preferential terms for the payment or repayment of taxes. BEPS Action Plan 5 requires satisfaction of substantial activity test for all such preferential regimes.

From infrastructure perspective, one of such preferential regime is shipping regime which provides a preferential tax treatment to shipping activities. As recommended by BEPS in Action Plan 5, shipping companies structured through preferential regimes would be required to demonstrate linkages between income qualifying for the benefits and core activities to earn the income. Considering the wide variation in the application of different countries' regimes, more detailed benchmark analysis needs to be undertaken for establishing link between core activities and demonstrating substantial activity by taxpayer.

On positive note, the OECD has recognized that tax concessions / incentives such as tax tonnage schemes provided by India are not harmful preferential regime and not covered under the measures suggested to encounter the same.



### **Impact on EPC players / agency contracts:**

Generally, contracts in the nature of Engineering, Procurement and Construction ('EPC') are structured into offshore supply / services and onshore supply / services, depending upon numerous factors, viz. nature of work involved, multiple contracting parties, etc. Some of the BEPS recommendations discussed below will have impact on EPC structures in India.

#### **Spitting of revenues into offshore and onshore**

BEPS Action Plan 7 takes into account various cases where a person tries to abuse the domestic tax laws by using treaty benefits (eg. mispricing of a transaction).

BEPS recommendations to address such mispricing issue is through appropriate transfer pricing mechanism which is dealt with Action Plan relating to transfer pricing and preventing the granting of treaty benefits by ensuring that appropriate domestic tax law provisions (for eg. GAAR) will prevail over the treaty provisions.

#### **Spitting of contracts**

BEPS Action Plan 7 has also discussed tax treaty abuse by an EPC payer by splitting-up contracts into several parts each covering less than 12 months and attributed to different companies within the same group for artificial avoidance of PE status and taxability of lower income in source country.

It is recommended that the above abuse should be addressed through the application of anti-abuse rules through suitable example, time spent by related parties to be aggregated for PE threshold, including an additional provision in tax treaty to address contract splitting.

From Indian standpoint, the tax authorities have alleged and attempted to disregard the splitting of the contracts, either by treating the entire income from turnkey contract being taxed as Association of persons ('AOP') or disregarding the split and taxing the offshore piece as well. Now the proposed BEPS recommendations, if incorporated under the Indian domestic tax laws / tax treaties entered into by India could result into prolonged litigation / considerable tax impact for EPC players.

A large construction crane is the central focus of the image, set against a clear blue sky. The crane's lattice structure is dark, and its long jib extends across the top of the frame. Below the crane, the skeletal framework of a building under construction is visible, with several workers silhouetted on different levels. The overall scene is one of active construction.

### Preparatory or Auxiliary activities

The BEPS report recognizes the fact that with dramatic changes in the way the business is conducted in current scenario, activities previously considered as preparatory or auxiliary activities may nowadays correspond to core business activities. Accordingly, BEPS report recommends that a combination of preparatory or auxiliary activities which may result into cohesive business operation will not be eligible for exclusion and result into PE exposure for foreign players.

### Agency PE

Further, BEPS report has expanded Agency PE scope to also include the agents virtually concluding the contracts and therefore, activities done by liaison office / marketing support services rendered by subsidiaries need to be re-assessed in view of extended definition.

### Use of Intermediary jurisdictions:

The BEPS Action Plan 6 has proposed to prevent treaty shopping and use of conduit companies. Consequently, in addition to country specific anti avoidance rules, Limitation of benefits (LOB) and Principal Purpose test (PPT) are also proposed for denial of treaty benefits.

### Other key BEPS recommendations relevant for infrastructure sector:

Apart from above, some of the other relevant BEPS recommendations are summarized below which will have impact on business models of infrastructure companies:

- Additional transfer pricing documentation and country by country reporting will put additional burden on taxpayers to reconsider the existing transfer pricing positions. Aforesaid reporting is intended to increase transparency across jurisdictions to identify whether companies have engaged in unfair practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments;
- Development of multilateral treaty provisions under BEPS Action Plan 15 is proposed as a most effective measure to implement treaty related recommendations. Some of the aspects intended to be covered under the multilateral treaty could be hybrid mismatch, countering tax treaty abuse, artificial avoidance of PE status, dispute resolution, etc.;
- Mandatory disclosure rules (BEPS Action Plan 12) wherein the objective is to obtain early information about potentially aggressive or abusive tax avoidance schemes and act as deterrent to reduce the promotion and use of such avoidance schemes.





## Conclusion

While the intent of BEPS Action Plans is to promote transparency, fair share of taxes to be paid by the taxpayers and fair allocation of taxes to each jurisdictions, the challenge lies in smooth and coordinated implementation across all countries considering the scale involved. Another challenge will be to respect and maintain the confidentiality of enormous strategic data to be collected by the tax officer across the geographies.

It will be imperative to watch-out for the manner in which countries amend their domestic tax laws to pave way for the recommendations under the BEPS report. For instance, will India amend GAAR / CFC provisions or introduce additional provisions, negotiate tax treaties or multilateral treaty provisions in order to give effect to BEPS recommendations. Hence, before implementing any BEPS recommendation, jurisdictions need to address the challenges in implementation of BEPS rules, transitional rules, grandfathering of existing structures etc. otherwise, unilateral changes in domestic tax laws may result into double taxation of income and could potentially lead to unwarranted controversies and tax litigation.

Though BEPS action plan have suggested measures for coherent international tax but at the same time, OECD has left room for discussion and flexibility to address country wise and sector wise issues. Infrastructure sector plays vital role in any country' development and considering the need and its importance, Government may give some relaxations in domestic laws such as higher interest ratio, investment based tax concessions, etc. However, such relaxations shall be based on guidance provided by OECD and not to be viewed as potentially harmful to other jurisdictions. Thus, BEPS rules may have come but nations has to implement them in spirit rather than words.

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